Making Our Mark

PROSPEX RESOURCES LTD.

Annual Report 2004



AR78

Forward-looking statement

Certain information regarding ProspEx Resources Ltd. ("ProspEx") set forth in this annual report, including management's assessment of the future plans, operations, expenditures and costs, contain forward-looking statements that involve substantial known and unknown risks and uncertainties. These forward-looking statements are subject to numerous risks and uncertainties, certain of which are beyond the control of ProspEx, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, the lack of availability of qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. The actual results, performance or achievement of ProspEx could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur, or if any of them do occur, what benefits ProspEx will derive therefrom.

The term barrels of oil equivalent ("boe") may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet to one barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

The Annual General Meeting of ProspEx's shareholders will be held on Monday, May 9, 2005, at 10:00 a.m. in the Lecture Theatre of the Metropolitan Centre, 333 – 4th Avenue S.W., Calgary, Alberta. All shareholders are welcome to attend. Those unable to do so are invited to complete, sign and return a Form of Proxy.

CORPORATE PROFILE



ProspEx is a junior oil and gas company focused on exploration in western Canada and headquartered in Calgary. Formed through a Plan of Arrangement with Esprit Exploration Ltd. (the "Plan of Arrangement") in October 2004, ProspEx is managed by a seasoned technical team comprised of former Esprit and Canadian Hunter Exploration managers. Our objective is to become a top quartile junior exploration company, by applying our technical and commercial expertise to create value and generate per share growth in production and reserves while applying cost discipline to maximize netbacks.

President's Message

ProspEx is one of the new players in the Canadian oil patch, formed from the reorganization of Esprit Exploration Ltd. in October 2004. Through the reorganization we inherited a balanced portfolio of assets and financial flexibility to exploit this portfolio. We have a talented and seasoned team of people with experience across the sedimentary basin, with particular expertise exploring in the Deep Basin area of northwest Alberta. We intend on utilizing our skills and assets to achieve strong production growth and increase shareholder value. ProspEx's early momentum reinforces my optimism. In the first three months following our launch, we increased production from an initial 1,470 barrels of oil equivalent per day (boe/d) to an average rate of 2,000 boe/d in the fourth quarter of 2004.

APPLYING A SIMPLE STRATEGY

Stated simply, our strategy is to use our balanced portfolio of assets to grow the Company through the drill bit while managing risk. To do this, we will focus primarily on developing low and medium risk, stacked targets in the Cretaceous, primarily within the "deep basin" fairway along the western edge of Alberta where reservoir rocks are typically gas saturated. These low and medium risk projects will be complemented by risk managed exposure to deeper Mississippian and Devonian plays to create additional upside growth.

Our "anchor" producing property is Medallion, a shallow, sweet, natural gas "resource play" opportunity located just 30 kilometres south of Calgary. Medallion currently provides approximately three quarters of our production from a series of stacked channels in the Belly River formation that offer multiple targets for lower risk, lower cost development drilling over a broad area. During the fourth quarter we drilled seven wells at Medallion, all of which were successful. Along with the tie-in of previously drilled wells, this program provided a 50% increase in Medallion production.

In western Canada, many gas producers struggle to replace annual declines of 25 to 30% or more on their existing production base. An attractive feature of the Medallion property is an inventory of exploitation drilling locations – both "downspacing" to drill a second well in each section to capture untapped reserves; and "step-out" drilling of undrilled sections. This inventory should allow ProspEx to maintain a stable base of production at Medallion, generating cash flow for reinvestment in our exploration programs in the Deep Basin and West Central Alberta.

An additional upside at Medallion is the potential to exploit coal bed methane ("CBM") deposits. CBM has been the target of intense industry activity north of Medallion, with a number of operators bringing commercial projects onstream over the past two years. With this success, CBM activity has moved south towards Medallion. While CBM potential at Medallion is unproved at this time, ProspEx believes it is highly prospective and is actively evaluating this opportunity.

Growth opportunities will be selected from the inventory of prospects on our undeveloped land base of 160,000 net acres.

GROWTH IN THE LONGER TERM

In the mid to long-term, we are targeting growth from our exploration program on our undeveloped land base of 160,000 net acres. These lands are primarily located in an area along the western margin of the Western Canadian Sedimentary Basin referred to as the "deep basin fairway". Anchored by Medallion in the south and the Deep Basin in the north, our focus will be low and medium risk exploration for Cretaceous clastics within this fairway. The ProspEx team has spent many years working in the deep basin fairway. We feel that this area is one of the most attractive exploration trends in western Canada, and are confident that the exploration concepts that we have developed in the past are applicable along the entire fairway.

The term "deep basin" denotes an area where the porous rocks are pervasively gas saturated, reducing the risk of encountering water and thus increasing the probability of exploration success. The area also features multiple productive horizons, which should allow us to "stack" two or more zones in any location, thereby reducing the risk of a dry hole and increasing production and reserves per wellbore. Within the deep basin fairway, reserves and productivity per well are typically higher than in the plains of Alberta. As a growing company in a maturing basin, we believe these attributes provide an excellent setting for a "drill bit" growth strategy.

The majority of our land base is located within this fairway, including 28,000 net undeveloped acres in the Deep Basin and 50,000 net undeveloped acres in Strachan/Ricinus in West Central Alberta.

In addition to our "bread and butter" program in Cretaceous clastics, we also have exposure to high impact exploration prospects which could add materially to our growth. These high impact prospects are Mississippian and Devonian carbonates in deep sour gas plays that are typically seismically driven and on trend with established production from the same horizons.

While we are not relying on success in these high impact prospects to meet our production targets, we see these prospects as potentially providing upside to our business plan. In a given year we expect to drill only one or two of these prospects, with less than 10% of our capital budget to be spent on high impact

wells. As we hold the rights to these prospects at high working interests, we expect to partner with other industry players to manage risk and costs.

MID-PROGRAM RESULTS

As we write this report, we are mid-way through our 2004/2005 winter exploration programs. To date, we have drilled three wells in the Elmworth and Wapiti areas, all of which were cased for natural gas production. In the Kakwa area of the Deep Basin, we have drilled two wells on ProspEx lands, one of which was cased for natural gas production. An additional well was drilled on a farm-in south of the ProspEx lands in the Kakwa area and was not successful. Completion and testing activities are underway on our four successful wells with the objective of tying-in as much of this production as possible prior to spring break-up.

We remain very confident in our team and our ability to extract value from the Deep Basin and our entire asset base. Although ProspEx's team is new to the junior exploration company scene, we are all seasoned and successful hydrocarbon explorers. Technically astute and commercially savvy, our team has a demonstrated track record of adding value through exploration. Our goal is to achieve top quartile performance throughout the commodity price cycle by employing pre-eminent technical skill to grow organically through the drill bit, exhibiting cost discipline and actively managing risk. Energetic and committed, we are eager to make our mark in the junior sector of the natural gas exploration industry.

FINANCIAL STRENGTH PROVIDES FLEXIBILITY AND STABILITY

In our industry, we know that opportunities come and go as commodity prices fluctuate across an ever broadening range. ProspEx's team believes strongly that the key to success lies in our ability to maintain flexibility and ensure we always have the capability to take advantage of opportunities as they emerge.

Energetic and committed, we are eager to make our mark in the junior sector of the natural gas exploration industry.

In December 2004, the Company closed a common share equity financing of 6.9 million shares at $2.90 per share for gross proceeds of $20 million. This financing allowed us to exit the year with no debt. Coupled with a $15 million credit facility and ongoing cash flow, this provides ProspEx with the financial capacity to execute our program in 2005, and to capture other opportunities that come our way.

PROSPEX IN 2005 AND BEYOND

Our team is excited about our prospects for 2005. Despite warm weather and high gas storage inventory levels, commodity prices remain close to the highest seen in the course of our careers. Our development program at Medallion has provided ProspEx with a solid foundation of production and cash flow, while our drilling programs in the Deep Basin and West Central Alberta offer the prospect of material growth. Finally, our "high impact" exploration program also adds to our enthusiasm for the coming year.

I would like to thank the team that has brought ProspEx into being. To the staff at ProspEx – you have done so much in a very short time frame to launch our Company with fantastic momentum. I am also grateful for the direction and support of our Board of Directors in these early days.

Most importantly however, I extend my appreciation to those who have shown confidence in our new team and continued faith in our plans for the future – our investors. I can tell you I am speaking for the entire ProspEx team when I say we are all absolutely committed to return your loyalty with continued success.

We look forward to making our mark,



John W. Rossall
President and Chief Executive Officer
March 3, 2005



R. SCOTT GODSMAN
Vice President, Land

Prior to joining ProspEx, Scott was the Vice President, Land at Esprit Exploration Ltd. Scott has extensive experience in the oil and gas industry, working with Burlington Resources Canada as Northern Asset Team Manager, and Canadian Hunter Exploration Ltd. as Land Manager, North Team. During Scott's 15-year career, he has also held positions with Chevron Canada Resources and Anderson Exploration.

Scott has a Bachelor of Commerce degree from the University of Calgary and is a member of Canadian Association of Petroleum Landmen (CAPL).



JEAN-PAUL (J.P.) H. LACHANCE
Vice President, Engineering

Prior to joining ProspEx, J.P. was a Senior Reservoir Engineer with Esprit Exploration Ltd. and prior to Esprit held positions with both Marathon Canada Limited and Chevron Canada Resources. He has worked for 14 years in the oil and gas industry in many engineering capacities as a Facilities, Production and Reservoir Engineer. J.P. has worked extensively on shallow and deep, sweet and sour gas plays throughout Alberta and northeast British Columbia.

J.P. has a Bachelor of Applied Science (Civil Engineering) degree from the University of Waterloo and is a professional engineer and a member of APEGGA.



PETER J. LUXTON
Vice President, Exploration

Prior to joining ProspEx, Peter was the General Manager of Geoscience with Esprit Exploration Ltd. Peter brings a wealth of knowledge about the Deep Basin to ProspEx from his previous positions with Burlington Resources Canada and Canadian Hunter Exploration Ltd.

Peter was instrumental to the exploration success achieved by Canadian Hunter in the 1990's that drove growth in production and reserves from the Deep Basin area. He was also responsible for expanding the boundaries of the commercial Deep Basin into previously under-explored areas. While at Esprit, Peter was responsible for assembling the Deep Basin assets which are expected to fuel the future growth of ProspEx.

Peter obtained a Bachelor of Science, with Honours, degree from Leicester University in England.



JOHN W. ROSSALL
President and
Chief Executive Officer

Prior to joining ProspEx, John was Vice President, North Business Unit at Burlington Resources Canada. His experience in the Deep Basin area of Alberta is extensive and dates back to 1990 with Burlington Resources and Canadian Hunter Exploration Ltd.

John earned a Bachelor of Applied Science (Chemical Engineering) degree from the University of Waterloo and later attended the Harvard Business School. John is a professional engineer and a member of APEGGA.



GEORGE D.K. YEE
Vice President, Finance,
Chief Financial Officer and
Corporate Secretary

Prior to joining ProspEx, George was Controller at Esprit Exploration Ltd. and prior to Esprit, held similar positions at Burlington Resources Canada and Canadian Hunter Exploration Ltd. George brings significant financial management experience to his role at ProspEx.

George earned his Bachelor of Commerce degree from the University of Calgary. He obtained his Chartered Accountant designation in Alberta, and completed his Master of Business Administration degree at the University of Calgary.

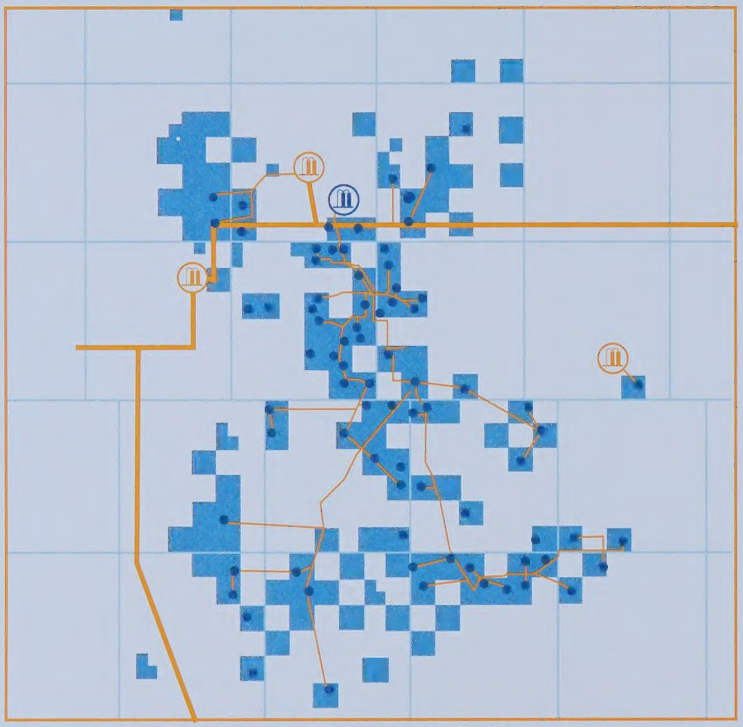
OPERATIONS REVIEW

ProspEx owns 160,000 net undeveloped acres of land, largely located within the "deep basin" fairway in western Alberta. ProspEx's core areas are Medallion, the Deep Basin and West Central Alberta. ProspEx also controls the rights to various high impact exploration prospects located in West Central Alberta.





MEDALLION


ProspEx Land
ProspEx Pipeline
Sales Line
Producing Wells
Non-Operated Facility
Operated Facility

Operations Review: Medallion

Medallion is ProspEx's "anchor" producing property – the source of three quarters of our initial production. Located 30 kilometres south of Calgary, Medallion offers a "resource play" style of opportunity, with a series of stacked channels in the Belly River formation providing relatively low risk development drilling over a broad area. Medallion offers year-round access to drilling and 100% ProspEx-owned infrastructure including compression and a gathering system. Drilling depths at Medallion are shallow – typically 1,000 to 1,400 metres. The average cost to drill, complete and tie-in a well at Medallion has been approximately $500,000.

In addition to drilling potential on the remaining 15,000 net acres of undeveloped lands, Medallion offers the opportunity to drill a second well in sections where there is already a producing well – referred to as "downspacing", in order to capture additional resources not drained by the first well. The downspacing concept was validated by our drilling program in 2004, and provides a larger inventory of lower risk development drilling. ProspEx intends to draw on this inventory of undeveloped land and downspacing to maintain a stable base of production at Medallion. This core production is expected to provide cash flow to fund drilling in other areas.

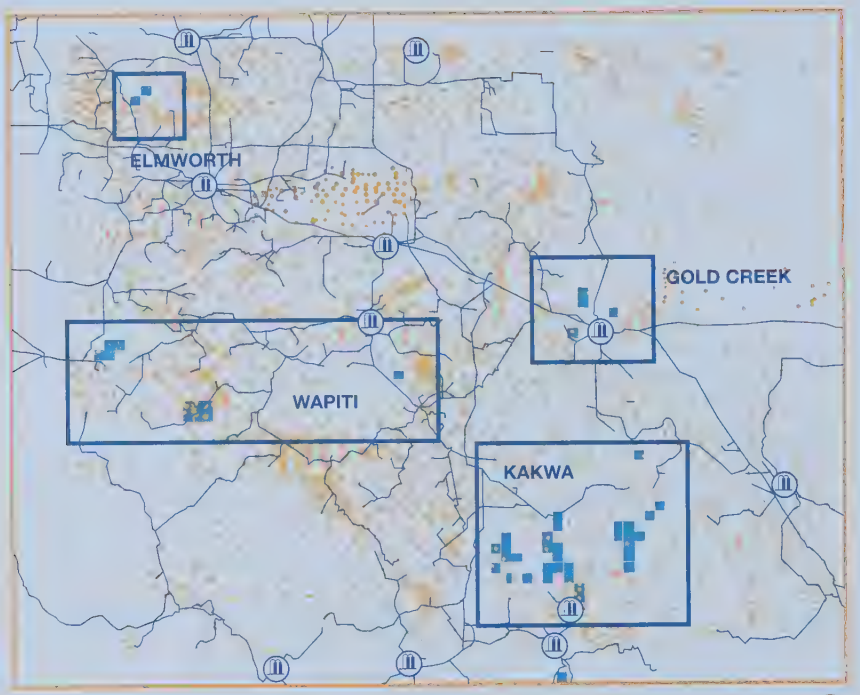
Over the fourth quarter of 2004, Medallion production averaged 1,613 boe/d, an increase of 51% over the third quarter average of 1,068 boe/d. This production growth was driven by the tie-in of 18 gross (18.0 net) wells, the majority of which were drilled in the third quarter. ProspEx continued an active drilling program in the area that began in the third quarter, and participated in seven gross (5.8 net) wells, with a 100% success rate. At December 31, 2004 ProspEx had an inventory of seven wells (five operated, two non-operated) awaiting pipeline connections at Medallion, representing approximately 200 boe/d of initial net production.

In the first quarter of 2005, ProspEx plans to operate the drilling of approximately 10 gross (10.0 net) new wells in the Medallion field, with three gross (1.1 net) additional partner operated wells anticipated. The inventory of seven wells awaiting pipeline connections will also be brought on-stream. This activity is intended to offset decline and maintain Medallion production near exit rate levels.

Coal bed methane ("CBM") has been the target of intense industry activity north of Medallion, with a number of operators bringing commercial CBM projects on-stream in the past two years. With this success, more recent activity has moved southward towards Medallion. In the first quarter of 2005, ProspEx participated in a CBM recompletion on the Medallion property that resulted in a commercial rate. The results of this recompletion and associated technical studies are encouraging, and ProspEx plans to continue to pursue CBM as an "add on" to existing and future wellbores drilled for deeper Belly River gas, with the ultimate objective of confirming the economics of CBM as a stand-alone project.



DEEP BASIN


ELMWORTH
GOLD CREEK
WAPITI
KAKWA
ProspEx Land
Wells
Non-Operated Facility
Pipelines

Operations Review: Deep Basin & West Central Alberta

The Deep Basin and West Central Alberta are expected to be the focus of ProspEx's medium risk exploration program.

The Deep Basin features multiple productive horizons in a pervasively gas saturated environment. At present, there are 17 different productive zones in the Deep Basin, providing the opportunity to "stack" two or more zones in a location, thereby reducing the risk of a dry hole and increasing production and reserves per wellbore. ProspEx owns a total of 28,000 net undeveloped acres of land in this area. ProspEx's management team brings extensive Deep Basin geological and engineering expertise from previous careers at Canadian Hunter Exploration and Burlington Resources.

ProspEx also owns 50,000 net acres of undeveloped lands in the Strachan and Ricinus areas in West Central Alberta. These lands host a variety of exploration opportunities ranging from Cretaceous targets such as the Cardium, Glauconitic and Ostracod to the deeper Mississippian Elkton formation.

In the Deep Basin and West Central Alberta, drilling depths are moderate, ranging from 2,000 to 3,500 metres on the ProspEx lands. Well costs reflect these depths, and usually range from $1.5 million to $3.5 million to drill, complete and tie-in.

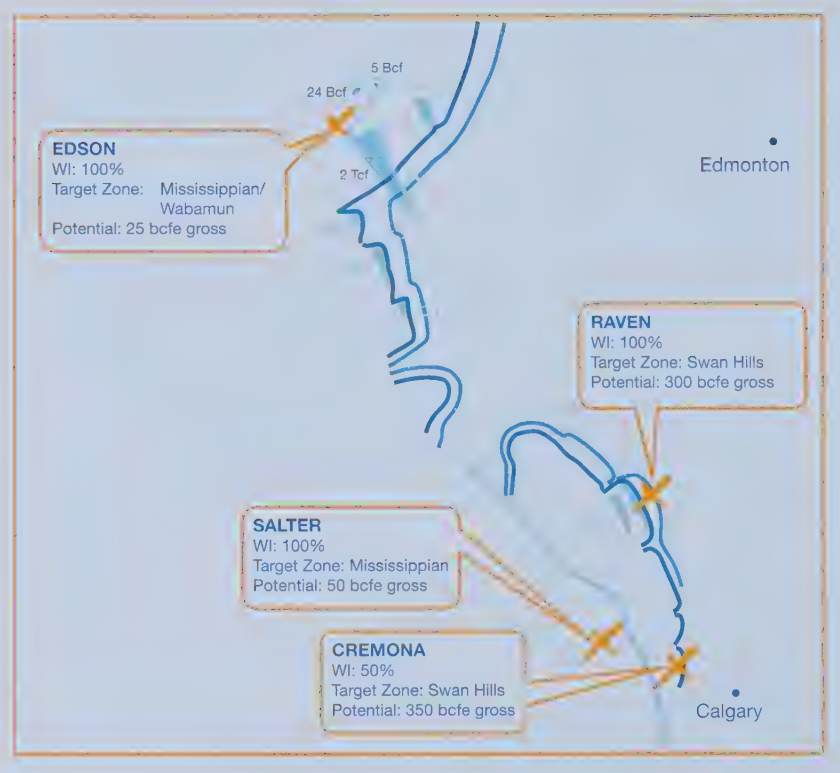
During the fourth quarter, ProspEx drilled two wells in the Deep Basin: one (1.0 net) successful well on ProspEx land in the Kakwa area, and a second (0.4 net) unsuccessful well on a farm-in on lands south of our core Kakwa land position, giving a net success rate of 71%. In the first quarter of 2005, ProspEx is continuing its drilling program in the Deep Basin in order to evaluate the Company's various parcels of land. Since January 1, 2005, the Company has drilled four additional (1.5 net) wells; of which one at Elmworth and two at Wapiti were successful and have been cased; with one well at Kakwa abandoned. At the time of writing, the four successful wells are in the completion and testing process.

Fourth quarter production for West Central Alberta averaged 385 boe/d, a 52% increase from an initial third quarter production of 253 boe/d. Since January 1, 2005, ProspEx's winter program has focused on recompletions and testing, securing land deals, and developing a drilling inventory for the summer program. An Ostracod well in Garrington and a Viking well in Willesden Green have successfully been re-completed and re-tested in the first quarter. It is expected that these wells will provide 100 boe/d of net production when tied-in.

In January 2005, ProspEx entered into an agreement to swap a portion of the Company's interests in certain lands in the Strachan area in exchange for eight gross (4.8 net) sections of Cretaceous rights within the Hoadley Glauconitic trend at Willesden Green. The Company believes that this exchange enhances ProspEx's asset base as these "deep basin" style assets fit in the core of our strategy, and relate directly to ProspEx's expertise. The Strachan interests involved in the exchange were predominantly in deeper plays. ProspEx has retained a 30 to 50% interest in these lands to be exposed to the upside potential of these deeper plays.

This activity has positioned ProspEx to undertake a summer drilling program in West Central Alberta. It is expected that this summer program will involve the drilling of four to six wells, starting in the third quarter of 2005.

HIGH IMPACT EXPLORATION



Operations Review: High Impact Exploration

ProspEx also has a number of exploration opportunities in our portfolio that we describe as "high impact". They are typically deep sour gas plays identified by seismic, on trend with wells producing from the same target zones. ProspEx holds the rights to these prospects at higher working interests, and anticipates partnering with other industry players to effectively manage risk associated with this type of high impact drilling.

ProspEx's ability to achieve its production targets is not dependent on the performance of these high impact prospects. Rather, it is ProspEx's view that these opportunities could provide additional upside to its business plan. Capital spent on high impact wells is expected to be less than 10% of ProspEx's total capital budget in any given year.

ProspEx has entered into an agreement to farm out a portion of our interests in the Salter area. The farmee has committed to drill a horizontal appraisal well in this structured Mississippian play, with the option to drill additional wells on ProspEx's 14,000 net acre land base at Salter. Given surface consultation and access issues in the area, the initial well may not be drilled until the first quarter of 2006.

The Company continues to work towards approval of a well license for our Raven Swan Hills prospect. Pending the receipt of a well license, ProspEx expects to drill this prospect in late 2005.

ProspEx has also been advancing its Edson Mississippian/Wabamun prospect. A location has been surveyed and the Company is commencing the surface consultation process in anticipation of applying for a drilling license later this year.

Reserves

An independent evaluation of ProspEx's reserves at January 1, 2005 was conducted by Gilbert Laustsen Jung Associates Ltd. ("GLJ") and prepared in accordance with the reporting guidelines of NI 51-101. Under NI 51-101, the "best estimate" for reserve balances and additions is the Proved plus Probable category. In this category the Company added 2.0 billion cubic feet ("bcf") of gas and 12 thousand barrels ("mbbls") of oil and natural gas liquids for total additions of 351 thousand barrels ("mboe") in the period October 1 to December 31, 2004. There were no revisions to Proved or Probable reserves in this period. ProspEx replaced 187% of reported production through exploration and development activities. Other than the initial reserves acquired through the Plan of Arrangement, there were no acquisitions of either Proved or Probable reserves in the period.

Capital spending for Medallion and the West Central Alberta programs totaled $5.9 million, resulting in finding and development costs of $14.26/boe on a Proved basis and $12.86/boe on a Proved plus Probable basis.

In the period October 1 to December 31, 2004, ProspEx spent $5.0 million on seismic and drilling in the Deep Basin. This program included the drilling of two wells (1.4 net) that were rig released prior to year end, and two additional wells (0.7 net) where drilling was in progress at year end. These four wells (2.1 net) resulted in two (1.2 net) successful wells; however as completion operations did not commence until 2005 no reserves were recognized at January 1, 2005. In addition to this drilling capital, ProspEx spent $1.0 million on seismic that will be used in part to identify future drilling locations. With this spending included, and no Deep Basin reserves recognized at December 31, overall finding and development costs were $32.14/boe on a Proved basis and $27.42 on a Proved plus Probable basis.

RESERVES RECONCILIATION

	Proved			*Proved plus Probable*		
	Oil & NGLs (mbbls)	*Gas (mmcf)*	*Oil Equivalent (mboe)*	*Oil & NGLs (mbbls)*	*Gas (mmcf)*	*Oil Equivalent (mboe)*
Opening Balance – Oct. 1, 2004	–	–	–	–	–	–
Drilling additions and improved recovery	9	1,658	286	12	2,035	351
Technical revisions	–	–	–	–	–	–
Net additions	9	1,658	286	12	2,035	351
Acquisitions and dispositions[1]	135	18,650	3,243	157	23,065	4,002
Total additions	144	20,308	3,529	169	25,100	4,353
Production	(4)	(1,080)	(184)	(4)	(1,080)	(184)
Closing balance – Jan. 1, 2005[2]	139	19,228	3,344	165	24,020	4,169

[1] Acquisitions represent the reserves acquired through the Plan of Arrangement.

[2] Numbers may not add due to rounding.

RESERVE BALANCE

Company Interest (working interest plus royalties receivable)

January 1, 2005

	Oil (mbbls)	*NGLs (mbbls)*	*Natural Gas (mmcf)*	*Oil Equivalent (mboe)*
Proved Producing	2.2	137	18,162	3,167
Proved Developed Non Producing	–	–	1,066	178
Proved Undeveloped	–	–	–	–
Total Proved	2.2	137	19,228	3,344
Proved plus Probable	2.5	163	24,020	4,169

FINDING AND DEVELOPMENT COSTS

	Proved	*Proved plus Probable*
CAPITAL *($ millions)*		
Future development capital		
January 1, 2005 [1]	1.9	2.6
October 1, 2004	3.8	4.0
Change in future development capital	(1.9)	(1.4)
Exploration & development capital	11.0	11.0
Total capital subject to F&D calculation	9.1	9.6
RESERVES [2]		
Net reserves additions for the period (mboe)	286	350
F&D Costs *($/boe)*	32.14	27.42

[1] Future development capital as of Oct. 1, 2004 as estimated by ProspEx management.

[2] No Deep Basin reserves were recognized at December 31, 2004.

PRESENT VALUE OF CASH FLOWS

ProspEx's reserves were evaluated using GLJ's January 1, 2005 price forecast. Cash flows are prior to income taxes and general and administrative expenses. Undeveloped land values are not included. Well abandonment costs have been included for wells that have reserves assigned.

	Discount Rate		
($ millions)	*0%*	*10%*	*12%*
Proved Producing	59.1	43.7	41.7
Proved Developed Non Producing	2.7	2.0	1.8
Proved Undeveloped	0.0	0.0	0.0
Total Proved	61.8	45.6	43.5
Total Proved plus Probable	76.0	52.4	49.6

GLJ January 1, 2005 Price Forecast

Year	*WTI Crude Oil ($US/bbl)*	*Edmonton Light Crude Oil ($Cdn/bbl)*	*Natural Gas at AECO ($Cdn/mmbtu)*
2005	42.00	50.25	6.60
2006	40.00	47.75	6.35
2007	38.00	45.50	6.15
2008	36.00	43.25	6.00
2009	34.00	40.75	6.00
2010	33.00	39.50	6.00
2011	33.00	39.50	6.00
2012	33.00	39.50	6.00
2013	33.50	40.00	6.10
2014	34.00	40.75	6.20
2015	34.50	41.25	6.30
Escalate thereafter at	+2.0%/yr	+2.0%/yr	+2.0%/yr



BRIAN E. HIEBERT

Brian has had extensive experience in managing several private E&P oil and gas companies. He has served as CEO for Leland Energy Ltd., Watford Energy Ltd., Markwest Hydrocarbons Inc. and B&G Energy Ltd. All these companies have been successful explorers in the Western Canadian Sedimentary Basin, adding significant reserves and value for their shareholders. Prior experience includes 14 years at Chevron Canada Resources where Brian worked as a geophysicist, geologist and held several roles in management.

Brian earned a Bachelor of Geologic Engineering (with a Geophysics option) degree from the University of Saskatchewan in 1980.



KYLE D. KITAGAWA

Kyle brings over 20 years experience in commodity trading, equity investing, and structured finance in both energy and energy intensive industries. Kyle serves on the boards of Ferus Gas Industries Trust, Independent Energy Ltd., Livingston Energy Ltd., Wave Energy Ltd. and Zargon Energy Trust. He served as chairman of Advanced Mobile Power Systems, LLC, and was a past director of Esprit Exploration Ltd., Invasion Energy Inc., and Papier Masson Ltee.

He holds a Master of Business Administration degree from Queen's University, a Bachelor of Commerce degree from the University of Calgary and is a Chartered Accountant.



IAN MACGREGOR

Ian is an independent businessman with 30 years of business creation and development experience. He founded several businesses including: Solex Energy, a private oil and gas company; Taylor Gas Liquids, a gas processing company; and North West Capital, a private investment company. His primary interests and responsibilities lie in the areas of finance, business development, and business turnarounds.

He is a director of Enmax Corporation as well as several private companies. Ian has a Bachelor of Science degree in Mechanical Engineering.



JOHN W. ROSSALL

Prior to joining ProspEx, John was Vice President, North Business Unit at Burlington Resources Canada. His experience in the Deep Basin area of Alberta is extensive and dates back to 1990 with Burlington Resources and Canadian Hunter Exploration Ltd.

John earned a Bachelor of Applied Science (Chemical Engineering) degree from the University of Waterloo and later attended the Harvard Business School. John is a professional engineer and a member of APEGGA.



STEPHEN J. SAVIDANT

Steve is President and CEO of Esprit Energy Trust, and Chairman of the ProspEx Board of Directors. He has 31 years of industry experience including 16 years with Canadian Hunter Exploration Ltd. prior to joining Esprit in 2002. He is an active member of the Calgary community and is currently Vice Chair of the Board of Governors of Mount Royal College and a director of Empire Company Limited.

Steve has a Bachelor of Engineering degree and a Master of Business Administration degree, both from McGill University.

Corporate Governance

The Board of Directors of ProspEx (the "Board") has the responsibility to oversee the conduct of the business of ProspEx and to oversee the activities of management who are responsible for the day-to-day conduct of the business of ProspEx.

The Board is to be constituted of a majority of individuals who qualify as unrelated directors. An unrelated director is one who is independent of management and is free from any interest and any business or other relationship which could or could reasonably be perceived to materially interfere with the director's ability to act with a view to the best interests of ProspEx, other than interests and relationships arising from shareholdings.

The Board operates by delegating certain of its authorities to management and by reserving certain powers to itself. The Board retains the responsibility of managing its own affairs including selecting its Chairman, nominating candidates for election to the Board, constituting committees of the full Board and determining compensation for the directors. Subject to the Articles and By-Laws of ProspEx and the *Business Corporations Act (Alberta)*, the Board may constitute, seek the advice of and delegate powers, duties and responsibilities to committees of the Board.

The Board's fundamental objectives are to enhance and preserve long-term shareholder value. In performing its functions, the Board should also consider the legitimate interests of other stakeholders such as employees, customers and communities. In broad terms, the stewardship of ProspEx involves the Board in strategic planning, financial reporting, risk management and mitigation, senior management determination, communication planning and internal control integrity.

The Board's mandate is to set the tone and oversee the conduct of ProspEx and its affiliates. This is to be directed in accordance with policies established by the Board from time to time including the Code of Conduct and the Environment Health & Safety policies. These policies outline, set the tone and guide the conduct and manner in which ProspEx is to conduct its business on a day-to-day basis. Each of these polices not only requires ProspEx to work within the legal requirements of operating a business, but also requires ProspEx and its affiliates to conduct business on the broader terms of being a responsible and safe corporate citizen.

ProspEx has two committees: the Corporate Governance and Compensation Committee, and the Audit Committee.

THE CORPORATE GOVERNANCE AND COMPENSATION COMMITTEE

Members: Brian E. Hiebert (Chairman), Ian MacGregor and Kyle D. Kitagawa

It is the policy of ProspEx to establish and maintain a Corporate Governance and Compensation Committee, composed entirely of independent directors, to assist the Board.

The Committee is responsible for:

- assessing the effectiveness of the Board as a whole, each committee of the Board, and the contribution of each individual director;
- addressing governance issues; and
- identifying, recruiting, compensating, endorsing, recommending appointment of, and orienting new directors.

The Committee is also responsible for ProspEx's human resources and compensation policies and processes. The Committee is to be provided with resources to commensurate with the duties and responsibilities assigned to it by the Board, including administrative support. If determined necessary by the Committee, it has the discretion to investigate and conduct reviews of any human resource or compensation matter including the standing authority to retain experts and, with approval of the Board, special counsel.

THE AUDIT COMMITTEE

Members: Kyle D. Kitagawa (Chairman), Ian MacGregor and Brian E. Hiebert

It is the policy of ProspEx to establish and maintain an Audit Committee, composed entirely of independent directors, to assist the Board in carrying out their oversight responsibility for the internal controls, financial reporting and risk management processes of ProspEx. The Audit Committee is to be provided with resources to commensurate with the duties and responsibilities assigned to it by the Board including administrative support. If determined necessary by the Audit Committee, it has the discretion to institute investigations of improprieties, or suspected improprieties within the scope of its responsibilities, including the standing authority to retain special counsel or experts.

Management's Discussion and Analysis

ProspEx Resources Ltd. ("ProspEx" and/or the "Company") commenced operations on October 1, 2004 when certain assets of Esprit Exploration Ltd. ("Esprit") were transferred to ProspEx upon the completion of a Plan of Arrangement (the "Plan of Arrangement"). The Plan of Arrangement resulted in, amongst other things, the shareholders of Esprit obtaining voting common shares in the capital of ProspEx.

The financial information in this report includes the operating results for ProspEx from the effective date of the Plan of Arrangement (October 1, 2004) to December 31, 2004. As a result, there is no comparative information.

Management's Discussion & Analysis ("MD&A") is the Company's explanation of its financial performance for the period covered by the consolidated financial statements along with an analysis of the Company's financial position. The following discussion and analysis is management's assessment of the consolidated financial and operating results of ProspEx as well as its future opportunities and risks, and should be read in conjunction with the audited consolidated financial statements and related notes of ProspEx for the period ended December 31, 2004. The reader should be aware that historical performance results are not necessarily indicative of future performance. Additional information relating to ProspEx, including our initial Annual Information Form (once filed), can be found at www.sedar.com. The Company anticipates filing its initial Annual Information Form prior to March 31, 2005.

NON - GAAP MEASURES

Within the MD&A references are made to terms commonly used in the oil and gas industry. The following terms are not defined by generally accepted accounting principles ("GAAP") in Canada and are referred to as non-GAAP measures.

1. Cash flow is defined as cash flow from operations before the change in non-cash working capital. The MD&A contains the term "cash flow" which should not be considered an alternative to, or more meaningful than "cash flow from operations" as determined in accordance with GAAP. The Company considers cash flow to be a key measure as it demonstrates the Company's ability to generate the cash necessary to fund capital projects and to repay debt. Cash flow presented does not have any standardized meaning prescribed by Canadian GAAP and therefore it may not be comparable with the calculation of similar measures for other entities. Cash flow per share is calculated using the same weighted average number of common shares for the period as used in calculating the net earnings per share calculation.
2. Barrel of oil equivalent ("boe") amounts have been calculated using a conversion rate of 6,000 cubic feet of gas to one barrel of oil. Boe may be misleading if used in isolation. A boe conversion ratio of one barrel of oil to six mcf of gas is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the well head.

3. Netbacks equal total revenue less royalties, operating costs and general and administrative costs on a boe basis. Total boes are calculated by multiplying the daily production by the number of days in the period.

FORWARD-LOOKING STATEMENTS

The MD&A contains forward-looking or outlook information with respect to ProspEx. The use of any of the words "anticipate", "continue", "estimate", "expect", "may", "will", "project", "should", "believe", "outlook", and similar expressions are intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in our forward-looking statements. We believe the expectations reflected in those forward-looking statements are reasonable. However, we cannot assure you that these expectations will prove to be correct. You should not unduly rely on forward-looking statements included in this report. These statements speak only as of the date of this MD&A.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of the risk factors set forth below and elsewhere in this MD&A.

- Volatility in market prices for oil and natural gas;
- Risks inherent in our operations;
- Geological, technical, drilling and processing problems;
- General economic conditions;
- Industry conditions, including fluctuations in the price of oil and natural gas;
- Governmental regulation;
- Fluctuation in foreign exchange and interest rates;
- Unanticipated events that can reduce production or cause production to be shut-in or delayed;
- Failure to obtain industry partner and other third party consents and approvals, when required;
- The need to obtain required approvals from regulatory authorities; and
- The other factors discussed under "Operational and Other Business Risks" in this MD&A.

VISION, CORE BUSINESS AND STRATEGY

ProspEx is a junior oil and gas exploration company based in Calgary, Alberta whose business activities are focused in the Western Canadian Sedimentary Basin. Our strategy is to create value primarily through the generation and drilling of exploration and development prospects as well as through the exploitation and development of our existing properties.

With our existing land base, experience and talented people, our primary strategy of creating value and growth is exploring and developing through the drill bit.

KEY PERFORMANCE DRIVERS

ProspEx's goal is to add value by discovering and developing economic oil and gas reserves through the drill bit. Efforts to achieve this are largely focused on managing risk and controlling costs. Key performance drivers such as reserve replacement, finding and development costs, operating and general and administrative costs are monitored.

In addition, ProspEx strives to ensure it receives competitive prices for commodities sold. Sales prices and overall netbacks are considered in achieving ProspEx's goal of adding overall shareholder value.

Finally, performance measures which are monitored are net income, cash flow, reserves added and production on a per common share basis. These measurements are used to determine overall performance of adding economic oil and gas reserves and production.

PLAN OF ARRANGEMENT & RELATED PARTY TRANSACTION

On October 1, 2004, ProspEx received its initial asset base under the terms of the Plan of Arrangement, which resulted in all Esprit shareholders effectively receiving, among other consideration, 0.20 of a common share of ProspEx for each common share of Esprit held.

Pursuant to the Plan of Arrangement, ProspEx began operations with approximately 1,470 barrels of oil equivalent per day ("boe/d") of production, 183,000 net acres of undeveloped lands, and approximately $70 million in future tax deductions.

In terms of its balance sheet and pursuant to the Plan of Arrangement, ProspEx was allocated the following net assets:

		(000's)
Capital assets	$	38,843
Future tax asset		5,432
Long-term debt		(10,654)
Asset retirement obligation		(3,492)
Net assets acquired and share capital issued	$	30,129

In conjunction with the Plan of Arrangement, the Company entered into a six month administrative and technical services agreement with Esprit, pursuant to which Esprit is to provide certain administrative and technical services to ProspEx on a cost recovery basis (the "Technical Services Agreement"). Total charges for the period for the Technical Services Agreement were $94,074.

In addition, ProspEx sells its production to Esprit for market prices less a marketing charge. Total charges for this marketing arrangement for the period were $22,012.

As a result of the method of the marketing ProspEx's products, a substantial portion of the Company's accounts receivable are with Esprit.

SUMMARY OF OPERATIONAL HIGHLIGHTS

For the Three Months Ended December 31, 2004

FINANCIAL ($000's, except per share amounts)		
Oil and gas revenue	$	7,302
Net earnings	$	1,105
Per share – basic		0.03
– diluted		0.02
Cash flow from operations	$	4,338
Per share – basic		0.10
– diluted		0.10
Total assets	$	77,368

PRODUCTION VOLUMES	
Natural gas (mcf/d)	11,740
Natural gas liquids (bbls/d)	37
Crude oil (bbls/d)	4
Total (boe/d) (6:1)	1,998

SALES PRICES	
Natural gas ($/mcf)	6.60
Natural gas liquids ($/bbl)	46.42
Crude oil ($/bbl)	49.74
Total ($/boe)	39.73

NETBACKS ($/boe)	
Price	39.73
Royalties	(7.49)
Operating costs	(5.82)
General and administrative costs	(2.70)
Total	23.72

CAPITAL ($000's)	
Drilling, completions and seismic	7,550
Plant and facilities	2,836
Land and lease	160
Capitalized general and administrative expenses	495
Office and computer assets	356
Total	11,397

RESULTS OF OPERATIONS

Acquired Property Operations

The following table summarizes the quarterly operating statistics of the property acquired on October 1, 2004

	2003				2004			
	Q1	*Q2*	*Q3*	*Q4*	*Q1*	*Q2*	*Q3*	*Q4*
TOTAL REVENUE ($000'S)	2,364	2,869	3,250	3,822	4,412	4,576	5,152	7,302
AVERAGE DAILY PRODUCTION								
Oil (bbls/d)	6	5	7	7	21	14	13	4
NGL (bbls/d)	26	29	28	43	54	45	43	37
Natural Gas (mcf/d)	3,607	4,502	6,002	7,511	7,573	7,665	8,502	11,740
Total (boe/d)	634	784	1,035	1,302	1,337	1,337	1,473	1,998
OVERALL NETBACKS ($/boe)								
Price	41.46	40.22	34.13	31.92	36.26	37.62	38.02	39.73
Royalties	(6.92)	(9.21)	(5.45)	(6.36)	(7.45)	(7.06)	(5.99)	(7.49)
Operating	(3.51)	(3.19)	(3.83)	(3.71)	(4.74)	(5.35)	(6.38)	(5.82)
Operating Netback	31.03	27.82	24.85	21.85	24.07	25.21	25.65	26.42

Note: Quarterly results for 2003 and Q1 - Q3 of 2004 are historical results of the assets transferred prior to the Plan of Arrangement.

Revenue

	($000's)
Oil	20
Gas	7,125
NGL	157
Total petroleum and natural gas sales	7,302

Production for the first three months of operations was 1,998 boe/d, an increase of approximately 36% from initial operations on October 1, 2004. The increase in production is the result of 18 wells brought on production in the Medallion area. ProspEx exits 2004 with production of approximately 2,100 boe/d. ProspEx anticipates production for the first quarter of 2005 to be 1,900 boe/d.

ProspEx's overall production mix for 2004 was 98% dry gas, with 81% of production coming from the Medallion property.

Average Selling Price	
Oil ($/bbl)	49.74
Gas ($/mcf)	6.60
NGL ($/boe)	46.42
Total average realized price ($/boe)	39.73

ProspEx realized a gas price of $6.60/mcf for the first three

months of operations. ProspEx currently markets 70% of its gas at the AECO monthly index while the remaining 30% is marketed at the AECO daily index.

Hedging

On occasion, ProspEx will enter into physical and financial fixed price contracts. ProspEx is authorized by the Board of Directors to hedge up to 50% of its production at any given time; however it is ProspEx's policy not to enter into any physical or financial fixed price contracts with a term of more than 18 months and any collar arrangements that go beyond two years.

At December 31, 2004, ProspEx had a costless collar for 2,500 GJ/d with a floor price of $6.00/GJ and a ceiling of $10.56/GJ at AECO. This collar is to expire on October 31, 2005.

Royalty Expense

For the three months ended December 31, 2004, ProspEx had a royalty rate of 18.8% of revenues. ProspEx's royalty expenses for the period are slightly lower than industry averages. Typically, crown royalties are at a higher rate scale than freehold and gross override royalties. With regards to ProspEx's current production, 65% of production is subject to crown royalty rates, with the remainder of production subject to lower freehold and gross override rates.

For 2005, the royalty rate is expected to remain under 20%.

Operating Costs

Operating costs for the period were $1.1 million or $5.82 per boe. Currently ProspEx operates approximately 90% of its production, allowing the Company to better control its costs.

ProspEx estimates operating costs to be approximately $5.75 per boe for 2005.

General and Administrative Expenses

Total general and administrative costs ("G&A") for the period were $1.0 million. ProspEx follows the full cost method of accounting for its petroleum and natural gas operations and as such 50% of these costs were capitalized leaving $0.5 million expensed or $2.70 per boe. G&A costs for 2004 on a per boe basis are slightly higher than our expected normalized annual basis as certain costs normally incurred over a full year such as the annual report, reserve report and audit fees have been included in the initial three month period. In addition, certain one time costs associated with the start-up of ProspEx were incurred in the period.

G&A costs are expected to decrease to $1.75 per boe for 2005. The projected decrease in G&A costs on a boe basis is a result of an anticipated increase in overall production levels, and the absence of start-up costs experienced in 2004.

On October 1, 2004 ProspEx entered into the Technical Services Agreement with Esprit pursuant to which Esprit provides certain administrative and technical services to ProspEx on a cost recovery

basis. The initial term of this agreement expires March 31, 2005. ProspEx is in the process of developing or outsourcing any services that have been provided under the Technical Services Agreement.

Interest and Bank Charges

Interest and bank charges were $6,425 for the period. These charges are a result of a minimal amount drawn on the line of credit for the reported period. ProspEx expects to draw from its line of credit to fund the capital program in the last half of 2005 as funds received from the December 2004 financing will be drawn down first. It is anticipated that there should be no interest expense in the first half of 2005.

Depletion, Depreciation and Amortization

Depletion, depreciation and amortization for the period was $1.6 million. The depletion rate was $8.65 per boe for the period.

It is anticipated the 2005 depletion rate on a per barrel basis will rise as the current cost environment is higher than the historical costs.

Stock-based Compensation

The Company accounts for all stock-based compensation using the fair value method. Under the fair value method of accounting, this compensation expense is recorded in the earnings statement over the vesting period. For the period October 1, 2004 to December 31, 2004, ProspEx recognized a stock-based compensation expense of $755,714.

Asset Retirement Obligations

ProspEx records the fair value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites, in the period in which they are incurred and a corresponding increase in the carrying amount of the related long-lived asset. The liability accretes until the retirement obligation is settled. The asset retirement costs are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred.

Income Taxes

ProspEx has accrued $17,000 in capital taxes for the three months ended December 31, 2004.

Additionally, ProspEx has recorded a future tax expense of $851,000 in the period.

ProspEx has approximately $78.7 million of income tax pools at December 31, 2004 and does not anticipate being cash taxable in 2005.

As at December 31, 2004, ProspEx has recorded on its balance sheet a future income tax asset of $4.9 million. ProspEx's future income tax asset is the result of the tax pools being $34 million greater than the carrying value of the assets for accounting purposes. Of the $34 million in excess pools, approximately $17 million of these income tax pools resulted in the recognition of a future income tax asset and the remaining excess pools have

been included in a valuation allowance. With greater certainty on utilization of these income tax pools, an additional asset may be recognized in future periods of operations.

Net Income and Cash Flow

As an outcome of strong commodity prices, production growth and cost control, net income for the three months ended December 31, 2004 reached $1.1 million and cash flow was $4.3 million. On a per common share basis, net earnings income was $0.03 basic and $0.02 diluted. Cash flow per common share, on both a basic and a diluted basis, was $0.10.

With continued production growth, strong commodity prices and cost control, the Company expects the trend of positive net income and cash flow for 2005 to continue.

Capital Expenditures

ProspEx incurred $11.4 million in capital expenditures in 2004 as follows:

		($000's)
Drilling, completions and seismic	$	7,550
Plant and facilities		2,836
Land and lease		160
Capitalized G&A		495
Office and computer assets		356
Total capital expenditures	$	11,397

During the period, the Company incurred $7.6 million in drilling expenditures for nine gross (7.2 net) wells in the quarter, resulting in eight gas wells (6.8 net) and one dry well (0.4 net). In addition, the Company incurred $2.8 million in plant and facilities with the majority of expenditures incurred to tie-in the southern leg of the Medallion gas gathering system.

For 2005, the Company anticipates drilling approximately 30 net wells, of which 20 are planned in Medallion, with the remainder to be drilled in the Deep Basin and West Central Alberta.

Liquidity and Capital Resources

As at December 31, 2004, ProspEx had the following resources available to fund its capital expenditure program:

		($000's)
Cash	$	20,219
Working capital		(8,327)
Bank facilities available		15,000
Total capital resources	$	26,892

At December 31, 2004 ProspEx had $11.9 million in cash and working capital available to fund the 2005 capital program. These funds arose primarily from the private placement that ProspEx completed on December 3, 2004 in which ProspEx received gross proceeds of $20.0 million on the issuance of 6.9 million common shares.

The 2005 capital program is expected to be funded through three capital sources: the net proceeds received from the private placement completed in December 2004, cash flow from operations and the $15 million existing bank credit facilities.

The Board of Directors has approved a 2005 capital budget of $40 million.

Bank Debt

As at December 31, 2004, there was no outstanding debt balance drawn on our credit facility. ProspEx anticipates it will draw against its bank facilities in the third quarter of 2005 to fund capital projects.

The facility is available by way of Canadian and US dollar prime rate based loans, LIBOR advances, bankers' acceptances and letters of credit. The credit facility is fully revolving until June 30, 2005 and may be extended at the mutual agreement of the Company and its lender for an additional year. If the credit facility is not extended, a balloon payment is required on July 1, 2006. This facility is secured by a $30 million demand debenture and a first floating charge on all petroleum and natural gas assets of the Company.

Share Capital

The Company completed a private placement of approximately 6.4 million common shares and 3.2 million warrants on October 1, 2004 for proceeds of approximately $9.0 million. These funds were used to reduce ProspEx's initial debt of approximately $10.7 million.

During the month of October 2004, all of the authorized 1.3 million Special Performance Units available under the Company's Special Performance Unit Plan were awarded and 1.9 million (of an available 2.6 million) stock options were granted under the terms of the Company's Stock Option Plan.

On October 29, 2004, the outstanding ProspEx 30 day options issued under the Plan of Arrangement to Esprit option holders were all exercised or expired. Proceeds of $1.7 million were received and were used to eliminate the initial long-term debt allocated to ProspEx by Esprit under the Plan of Arrangement.

On December 3, 2004, ProspEx completed a private placement of 6.9 million common shares for gross proceeds of $20.0 million. These funds will be used in 2005 to continue to fund the 2005 exploration and development of ProspEx's oil and natural gas projects.

As at December 31, 2004, ProspEx had 47,110,724 common shares, 3,214,285 warrants, 1,307,995 Special Performance Units and 1,862,005 options issued and outstanding.

As at February 23, 2005, ProspEx had 47,103,581 common shares, 3,210,714 warrants, 1,307,995 Special Performance Units and 2,097,005 options issued and outstanding.

Contractual Obligations

The Company has committed to certain payments over the next five years as follows:

Payments due ($000's)	*2005*	*2006*	*2007*	*2008*	*2009*	*Thereafter*
Technical Services Agreement	94	–	–	–	–	–
Software licenses	29	42	57	–	–	–
Total	123	42	57	–	–	–

OPERATIONAL AND OTHER BUSINESS RISKS

Need to Replace and Grow Reserves

The future oil and natural gas production of ProspEx, and therefore future cash flows, are highly dependent upon ongoing success in exploring its current and future undeveloped land base, exploiting the current producing properties, and acquiring or discovering additional reserves. Without reserve additions through exploration, acquisition or development activities, reserves and production will decline over time as reserves are depleted.

The business of discovering, developing, or acquiring reserves is capital intensive. To the extent cash flows from operations are insufficient and external sources of capital become limited or unavailable, the ability of ProspEx to make the necessary capital investments to maintain and expand its oil and natural gas reserves may be impaired.

There can be no assurance that ProspEx will be able to find and develop or acquire additional reserves to replace and grow production at acceptable costs.

Exploration, Development and Production Risks

Oil and natural gas exploration involves a high degree of risk, which even a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that expenditures made on future exploration by ProspEx will result in new discoveries of oil and natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones, tools lost in the hole and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The long-term commercial success of ProspEx depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. No assurance can be given that ProspEx will be able to continue to locate satisfactory properties for acquisition or participation. Moreover, if such acquisitions or participations are identified, ProspEx may determine that current markets, terms of acquisition and participation or pricing conditions make such acquisitions or participations uneconomic.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operating conditions may adversely affect the production from successful wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage or transportation capacity or other geological

and mechanical conditions. While diligent well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

In addition, oil and gas operations are subject to the risks of exploration, development and production of oil and natural gas properties, including encountering unexpected formations or pressures, premature declines of reservoirs, blowouts, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

Reserve Estimates

The production forecast and recoverable estimates contained in the ProspEx Engineering Report are only estimates and the actual production and ultimate recoverable reserves from the properties may be greater or less than the independent estimates of GLJ.

There are numerous uncertainties inherent in estimating quantities of reserves and cash flows to be derived therefrom, including many factors that are beyond the control of ProspEx. The reserve and cash flow information set forth herein represent estimates only. The reserves and estimated future net cash flow from the assets of ProspEx have been independently evaluated effective January 1, 2005 by GLJ. These evaluations include a number of assumptions relating to factors such as initial production rates, production decline rates, ultimate recovery of reserves, timing and amount of capital expenditures, marketability of production, future prices of oil and natural gas, operating costs and royalties and other government levies that may be imposed over the producing life of the reserves. These assumptions were based on price forecasts in use at the date the relevant evaluations were prepared and many of these assumptions are subject to change and are beyond the control of ProspEx. Actual production and cash flows derived therefrom will vary from these evaluations, and such variations could be material. The foregoing evaluations are based in part on the assumed success of exploitation activities intended to be undertaken in future years. The reserves and estimated cash flows to be derived therefrom contained in such evaluations will be reduced to the extent that such exploitation activities do not achieve the level of success assumed in the evaluations.

Volatility of Oil and Natural Gas Prices

The operational results and financial condition of ProspEx will be dependent on the prices received for oil and natural gas production. Oil and natural gas prices have fluctuated widely during recent years and are determined by supply and demand factors, including weather and general economic conditions as well as conditions in other oil and natural gas regions. Any decline in oil and natural gas prices could have an adverse effect on the operations, proved reserves, and financial conditions of ProspEx

and could result in a reduction of the net production revenue of ProspEx causing a reduction in its oil and gas acquisition and development activities. In addition, bank borrowings which might be made available to ProspEx are typically determined in part by the borrowing base of the reserves of ProspEx. A sustained material decline in prices from historical average prices could reduce the borrowing base of ProspEx, therefore reducing the bank credit available to ProspEx and could require that a portion of such bank debt be repaid.

ProspEx uses the full cost method of accounting for oil and natural gas properties. Under this accounting method, capitalized costs are reviewed on a quarterly basis for impairment to ensure that the carrying amount of these costs is recoverable based on expected future cash flows. To the extent that such capitalized costs (net of accumulated depreciation and depletion) less future taxes exceed the present value of estimated future net cash flows from the proved oil and natural gas reserves of ProspEx, those excess costs would be required to be charged to operations.

Operational Hazards and Other Uncertainties

Oil and natural gas exploration operations are subject to all the risks and hazards typically associated with such operations, including hazards such as fire, explosion, blowouts, and oil spills, each of which could result in substantial damage to oil and natural gas wells, production facilities, other property and the environment or in personal injury. In accordance with industry practice, ProspEx is not fully insured against all of these risks, nor are all such risks insurable. Although ProspEx will maintain liability insurance, where available, in an amount which it considers adequate and consistent with industry practice, the nature of these risks is such that liabilities could exceed policy limits, in which event ProspEx could incur significant costs that could have a material adverse effect upon its financial condition. Business interruption insurance may also be purchased for selected facilities, to the extent that such insurance is available. Oil and natural gas production operations are also subject to all the risks typically associated with such operations, including premature decline of reservoirs and the invasion of water into producing formations.

Oil and natural gas exploration and development activities are dependent on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such equipment or access restrictions may affect the availability and/or cost of such equipment to ProspEx and may delay exploration and development activities. To the extent ProspEx is not the operator of its oil and gas properties, ProspEx will be dependent on other operators for timing of activities related to non-operating properties and will be largely unable to direct or control the activities of the operators.

Although property title reviews will be done according to industry standards prior to the purchase of most oil and natural gas producing properties or the commencement of drilling wells, such

reviews do not guarantee or certify that an unforeseen defect in the chain of title will not arise to defeat the claim of ProspEx which could result in a reduction of the revenue received by ProspEx.

Competition

There is strong competition relating to all aspects of the oil and natural gas industry. ProspEx will actively compete for capital, skilled personnel, undeveloped land, reserve acquisitions, access to drilling rigs, service rigs and other equipment, access to processing facilities and pipeline and refining capacity, and in all other aspects of its operations with a substantial number of other organizations, many of which may have greater technical and financial resources than does ProspEx.

Key Personnel

The success of ProspEx will depend in large measure on certain key personnel. The loss of the services of such key personnel could have a material adverse affect on ProspEx. ProspEx does not have key person insurance in effect for management. The contributions of these individuals to the immediate operations of ProspEx are likely to be of central importance. In addition, the competition for qualified personnel in the oil and natural gas industry is intense and there can be no assurance that ProspEx will be able to continue to attract and retain all personnel necessary for the development and operation of its business.

Environmental Risks

The oil and natural gas industry is subject to environmental regulation pursuant to a variety of international conventions and Canadian federal, provincial and municipal laws, regulations, and guidelines. A breach of such regulations may result in the imposition of fines or issuances of clean up orders in respect of ProspEx or its assets. Such regulation may be changed to impose higher standards and potentially more costly obligations on ProspEx. There can be no assurance that future environmental costs will not have a material adverse effect on ProspEx.

CRITICAL ACCOUNTING ESTIMATES

ProspEx's significant accounting policies are contained in note 1 to the consolidated financial statements. Certain of these policies are recognized as critical because in applying these policies management is required to make judgments, assumptions and estimates that have a significant impact on the financial results of ProspEx. The estimates used in applying these critical accounting policies have been discussed with the Audit Committee and are outlined below.

Oil and Gas Reserves

One hundred percent of the Company's proved plus probable oil and gas reserves were evaluated and reported on by an independent qualified reserves evaluator. However, the process of estimating oil

and gas reserves is complex and is subject to uncertainties and interpretations. Estimating reserves requires significant judgments based on available geological and reservoir data, past production and operating performance and forecasted economic and operating conditions. These estimates may change substantially as additional data from ongoing development, testing and production becomes available, and due to unforeseen changes in economic conditions which impact oil and gas prices and costs. The Company's reserves and revisions to those reserves have a significant impact on net earnings as they are a key component in calculating depletion of oil and gas assets and oil and gas asset impairments. Net revisions during the current period were insignificant.

Asset Impairment

ProspEx follows the Canadian Institute of Chartered Accountants ("CICA") Accounting Guideline 16 for full cost oil and gas accounting. In accordance with full cost accounting, a ceiling test is performed, on a quarterly basis, to test for impairment. An impairment loss is recorded if the sum of the undiscounted cash flows expected from the production of the proved reserves and the lower of cost and market of unproved properties does not exceed the carrying values of the oil and gas assets. An impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties.

The cash flows used in testing for impairment are based on a number of estimates, the two most significant being future prices and reserves. The uncertainty in reserves is discussed above. We estimate our future prices based on the forward market adjusted for basis, quality and transportation at the end of the period for the first 10 years after which the estimate of price is determined by our independent reserve evaluator. Although these price estimates are independent of the Company, they are still subject to significant volatility. Operating costs are estimated using current operating costs per barrel plus an inflation factor.

Certain costs related to unproved properties are excluded from costs subject to depletion until proved reserves have been determined or their value is impaired. These properties are reviewed quarterly and any impairment is transferred to the costs being depleted.

Asset Retirement Obligations

The Company records a liability for the legal obligation associated with the retirement of long-lived assets and a corresponding increase in the related asset in accordance with the method outlined by the CICA. The future liability is comprised of estimates of future costs to abandon and restore a well site and natural gas processing plants. The estimation of these costs are based on engineering estimates using current costs and technology and in accordance with current legislation and industry practice. These

estimates are reviewed annually and could impact net earnings through an adjustment to the depletion, depreciation and amortization rate used by the Company.

Income Taxes

ProspEx follows the liability method of accounting for income taxes. At the end of each reporting period the Company estimates its tax pool balances and quantifies differences between the tax pool balances and the accounting balances. The Company has an excess of tax pools over its accounting balances. As a result, it has recorded a tax asset on that portion of excess tax pools where there is a high degree of certainty the tax pools will be utilized in the future. The determination of the amount of the tax asset is a matter of judgment. With the complexity of income tax laws and the use of estimates in determining the utilization of income tax pools, the income tax asset or liability may differ from that recorded by ProspEx.

ProspEx's income and other tax liabilities require interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of time. Accordingly, the actual income tax asset or liability may differ significantly from that estimated and recorded by ProspEx.

NEW ACCOUNTING PRONOUNCEMENTS

Earnings per Share

In July 2004, the CICA issued an exposure draft for a new method for calculating year-to-date fully diluted earnings per share for fiscal years beginning on or after January 1, 2005. Under the new method, the incremental shares included in the year-to-date diluted earnings per share will be computed using the average market price of common shares of ProspEx for the year-to-date period. The Company will adopt this new guideline on January 1, 2005, but does not expect it to have a material impact on its financial position or results of operations.

Subsequent Events

In March 2004, the CICA issued an exposure draft that proposes to extend the period during which subsequent events are required to be considered to include those events that occur between the date of the balance sheet and the date when the financial statements are authorized for issue, and require disclosure in the financial statements of the date the financial statements were authorized for issue and who gave that authorization. Currently, subsequent events are only disclosed if they occur prior to the audit report date. This proposed exposure draft is effective for fiscal periods beginning on or after January 1, 2005. ProspEx will adopt this new guideline in the first quarter of 2005.

Management's Discussion and Analysis dated February 23, 2005

Management's Report

Management has prepared the consolidated financial statements in accordance with accounting principles generally accepted in Canada. If alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgments. Management has ensured that the consolidated financial statements are presented fairly in all material respects. Management has also prepared the financial information presented elsewhere in the annual report and ensured that it is consistent with information in the consolidated financial statements.

ProspEx Resources Ltd. maintains internal accounting and administrative controls designed to provide reasonable assurance that the financial information is relevant, reliable and accurate and that assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for reviewing and approving the consolidated financial statements and Management's Discussion and Analysis and, primarily through its Audit Committee, ensures that management fulfills its responsibilities for financial reporting.

The Audit Committee is appointed by the Board and is composed of Directors who are not employees of the Company. The Audit Committee meets regularly with management and with the external auditors to discuss internal controls and reporting issues and to satisfy itself that each party is properly discharging its responsibilities. It reviews the consolidated financial statements and the external auditors' report. The Audit Committee also considers, for review by the Board and approval by the shareholders, the engagement or reappointment of external auditors.

KPMG LLP, the external auditors, have audited the consolidated financial statements in accordance with the auditing standards generally accepted in Canada on behalf of the shareholders. KPMG LLP have full and free access to the Audit Committee.



John W. Rossall
President and Chief Executive Officer
Calgary, Canada
February 23, 2005



George D.K. Yee
Vice President, Finance & Chief Financial Officer

Auditors' Report

TO THE SHAREHOLDERS OF PROSPEX RESOURCES LTD.

We have audited the consolidated balance sheet of ProspEx Resources Ltd. as at December 31, 2004 and the consolidated statement of earnings and retained earnings and cash flows for the period from August 13, 2004 (date of incorporation) to December 31, 2004. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2004 and the results of its operations and its cash flows for the period from August 13, 2004 to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants
Calgary, Canada
February 23, 2005

Consolidated Balance Sheet

As At December 31, 2004
(Stated in thousands of dollars)

ASSETS	
Current assets	
Cash	$ 20,219
Accounts receivable	3,513
Prepaid expenses	2
	23,734
Capital assets, net (note 3)	48,705
Future income tax asset (note 4)	4,929
	$ 77,368
LIABILITIES	
Current liabilities	
Accounts payable and accrued liabilities	$ 11,842
Asset retirement obligation (note 5)	3,584
	15,426
SHAREHOLDERS' EQUITY	
Share capital (note 6)	60,081
Contributed surplus	756
Retained earnings	1,105
	61,942
	$ 77,368

See accompanying notes to consolidated financial statements.

Approved by the Board of Directors

Stephen J. Savidant

John W. Rossall

Consolidated Statement of Earnings and Retained Earnings

For the Three Months Ended December 31, 2004
(Stated in thousands of dollars, except per share amounts)

Revenue		
Oil and gas	$	7,302
Royalties		(1,376)
		5,926
Expenses		
Operating		1,070
Depletion, depreciation and amortization		1,583
General and administrative		495
Interest and bank charges		6
Stock-based compensation		756
Accretion of asset retirement obligation (note 5)		43
		3,953
Operating earnings before income taxes		1,973
Income taxes (note 4)		
Current		17
Future		851
		868
Net earnings for the period		1,105
Retained earnings, beginning of period		–
Net earnings for the period, being retained earnings at the end of the period	$	1,105
Net earnings per share – basic	$	0.03
Net earnings per share – diluted	$	0.02

See accompanying notes to consolidated financial statements.

Consolidated Statement of Cash Flow

For the Three Months Ended December 31, 2004
(Stated in thousands of dollars)

OPERATIONS	
Net earnings for the period	$ 1,105
Items not involving cash	
Depletion, depreciation and amortization	1,583
Stock-based compensation	756
Accretion of asset retirement obligation	43
Future income taxes	851
	4,338
Changes in non-cash working capital	3,864
	8,202
FINANCING	
Issuance of shares	29,605
Repayment of long-term debt	(10,654)
	18,951
INVESTMENTS	
Exploration and development expenditures	(11,041)
Other capital assets	(356)
	(11,397)
Changes in non-cash working capital	4,463
	(6,934)
Change in cash	20,219
Cash, beginning of period	–
Cash, end of period	$ 20,219

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Period from August 13, 2004 to December 31, 2004

1. SIGNIFICANT ACCOUNTING POLICIES

ProspEx Resources Ltd. ("ProspEx") was incorporated on August 13, 2004 and commenced operations on October 1, 2004 when certain assets of Esprit Exploration Ltd. ("Esprit") were transferred to ProspEx under a Plan of Arrangement (the "Plan of Arrangement"). The Plan of Arrangement resulted in, amongst other matters, Esprit shareholders becoming shareholders of ProspEx. ProspEx is engaged in the acquisition, exploration, development and production of oil and natural gas in Canada.

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results may differ from these estimates.

(a) Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary. A substantial portion of the Company's activities are conducted jointly with others and the consolidated financial statements reflect only the Company's proportionate interest in such activities.

(b) Capital Assets

The Company follows the full cost method of accounting for exploration and development expenditures whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves are capitalized. Such costs include lease acquisition, geological and geophysical, lease rentals on undeveloped properties, drilling both productive and non-productive wells, production equipment and overhead charges directly related to acquisition, exploration and development activities. Proceeds received from disposals of properties and equipment are credited against capitalized costs unless the disposal would alter the rate of depletion and depreciation by more than 20%, in which case a gain or loss on disposal is recorded.

All costs of acquisition, exploration and development of oil and gas reserves, associated tangible plant and equipment costs, and estimated costs of future development of proved undeveloped reserves are depleted and depreciated by the unit of production method based on estimated gross proved reserves before royalties as determined by independent engineers. Oil and gas reserves are converted to equivalent units using their relative energy content. Costs of unproved properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment has occurred.

Oil and gas assets are evaluated in each reporting period to determine that the costs are recoverable and do not exceed the fair value of the properties. The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost and market of unproved properties exceed the carrying value of the oil and gas assets. If the carrying value of the oil and gas assets is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. The cash flows are estimated using future product prices and costs and are discounted using the risk-free rate.

Amortization of capital assets not related to oil and gas assets is provided using the declining balance method at a rate from 20 to 50% per annum. Leasehold improvements are amortized using the straight-line method over the terms of the respective leases.

(c) Asset Retirement Obligation

The Company records the fair value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites, in the period in which they are incurred and a corresponding increase in the carrying amount of the related long-lived asset. The liability accretes until we expect to settle the retirement obligation. The asset retirement costs are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred.

(d) Income Taxes

The Company follows the liability method of accounting for future income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the amounts reported in the financial statements and the tax basis of the assets and liabilities, and are measured using the currently enacted, or substantively enacted, tax rates and laws expected to apply when these differences reverse. A valuation allowance is recorded against any future income tax asset if it is more likely than not that the asset will not be realized.

(e) Stock-based Compensation

Stock options and Special Performance Units granted have been accounted for based on the fair value method. The fair value is measured at the grant date and charged to earnings over the vesting period with a corresponding increase in contributed surplus. For awards that vest on a graded basis, compensation cost is recognized on a pro-rata basis over the vesting period. Consideration paid to the Company on exercise of all options is credited to share capital.

(f) Financial Instruments

The Company uses certain derivative financial instruments to manage its commodity price, foreign currency and interest rate exposures. These financial instruments are entered into solely for hedging purposes and are not used for trading or other speculative purposes. The Company has elected to use hedge accounting for qualifying instruments. These instruments are not recognized in the financial statements on inception. Gains or losses arising from financial instruments on commodity prices and foreign currency are recognized as adjustments to the related revenue accounts when the gain or loss is realized. Payments and receipts under interest rate swap contracts are recognized as adjustments to interest expense on long-term debt.

(g) Earnings Per Share

The Company uses the treasury stock method to determine the dilutive effect of outstanding stock options, Special Performance Units and warrants. Basic and diluted earnings per share are calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. Anti-dilutive options and warrants are excluded from the calculation.

(h) Revenue Recognition

Revenue from the sale of crude oil, natural gas and natural gas liquids is recorded when title passes.

2. PLAN OF ARRANGEMENT/RELATED PARTY TRANSACTION

Effective October 1, 2004, pursuant to the Plan of Arrangement, Esprit transferred certain property, plant and equipment to ProspEx. The Plan of Arrangement resulted in, amongst other matters, Esprit shareholders receiving 0.20 of a voting common share of ProspEx for every common share in Esprit. 32,810,106 common shares were issued as a result of the Plan of Arrangement. At the time of the transaction, Esprit and ProspEx were related parties resulting in the transfer of assets at Esprit's carrying value. The net assets transferred are comprised of as follows:

	($000's)
Capital assets	$ 38,843
Future tax asset	5,432
Long-term debt	(10,654)
Asset retirement obligation	(3,492)
Net assets transferred	$ 30,129

In conjunction with the Plan of Arrangement, ProspEx and Esprit entered into an administrative and technical service agreement pursuant to which Esprit is to provide certain administrative and technical services to ProspEx until March 31, 2005. Total charges for the period for the Technical Services Agreement were $94,074.

ProspEx also has a marketing arrangement with Esprit, under which ProspEx sells its production to Esprit for market prices

less a marketing charge. As a result of the marketing arrangement a substantial portion of the Company's accounts receivable as at December 31, 2004 are due from Esprit. Total charges for the period for the marketing agreement were $22,012.

3. CAPITAL ASSETS

	($000's)
Oil and gas properties	$ 49,932
Other	356
	50,288
Less accumulated depletion, depreciation and amortization	(1,583)
Total capital assets	$ 48,705

At December 31, 2004, oil and gas properties included $18 million of unproved properties which have been excluded from the depletion calculation. Future development costs related to proved undeveloped reserves of $1.9 million are included in the depletion calculation.

During 2004, the Company capitalized $0.5 million of overhead directly related to acquisition, exploration and development activities.

At December 31, 2004, the Company applied a ceiling test to its oil and gas assets using expected future market prices of:

	2005	*2006*	*2007*	*2008*	*2009*	*Thereafter*
Gas ($ per thousand cubic feet)[1]	6.16	6.15	5.95	5.50	5.23	+2%
Natural gas liquids ($ per barrel)[1]	38.87	36.44	35.10	33.92	33.43	+2%
Oil ($ per barrel)[2]	44.65	41.85	40.32	38.96	38.40	+2%

[1] Weighted average plantgate price

[2] Weighted average wellhead price

4. FUTURE INCOME TAXES

The provision for future income taxes differs from the amount computed by applying the combined expected Canadian Federal and Provincial tax rates to earnings before income taxes. The reasons for these differences are as follows:

	($000's)
Earnings before income taxes	$ 1,973
Rate	33.62%
Computed expected provision for future income taxes	663
Increase (decrease) in taxes resulting from:	
Non-deductible crown payments	263
Resource allowance	(274)
Stock-based compensation	254
Other	(55)
	851
Capital taxes	17
Income tax expense	$ 868

The components of the future income tax asset at December 31, 2004 are as follows:

	($000's)
Tax assets:	
Capital assets	$ 9,077
Asset retirement obligation	1,205
Share issue costs	278
	10,560
Valuation allowance	(5,631)
Future income tax asset	$ 4,929

At December 31, 2004, the Company had estimated tax deductions available to reduce future taxable income of $78 million.

5. ASSET RETIREMENT OBLIGATION

		($000's)
Balance, beginning of period	$	–
Liabilities incurred		49
Assumed liability pursuant to the Plan of Arrangement		3,492
Accretion expense		43
Balance, end of period	$	3,584

Key Assumptions		
Year in which obligation is expected to be settled:		*($000's)*
2005 – 2013	$	1,125
Thereafter		6,174
Undiscounted estimated cash flows required to settle the obligation	$	7,299
Credit adjusted risk-free rate		7.03%

6. SHARE CAPITAL

(a) Authorized

An unlimited number of common shares and non-voting common shares and an unlimited number of preferred shares are authorized for issuance.

(b) Common Shares and Common Share Performance Warrants Issued

	Number of Shares/Warrants (thousands)		*Amount ($000's)*
Balance, October 1, 2004 (see note 2)	32,810	$	30,129
Issued for cash on exercise of transferred options[1]	972		1,654
Issued for cash as private placement – October 1, 2004[2]	6,429		9,000
Less: Value ascribed to common share performance warrants	–		(1,965)
Issued for cash as private placement – December 3, 2004	6,900		20,010
Issue costs, net of future tax reduction of $348	–		(712)
Common shares balance as at December 31, 2004	47,111		58,116
Common share performance warrants	3,214		1,965
Share Capital as at December 31, 2004[3]		$	60,081

[1] Options were transferred as part of the Plan of Arrangement and were exercised in October 2004.

[2] 64% of the private placement was with officers, directors and employees of ProspEx.

[3] The legal stated capital is approximately $85 million.

(c) Common Share Performance Warrants

On October 1, 2004 ProspEx completed a private placement of 6.429 million common shares and 3.2 million warrants for gross proceeds of $9.0 million. Each warrant entitles the holder to acquire a common share at a price of $1.40. The warrants expire on October 1, 2009. The fair value of the warrants was estimated to be $1.9 million, using the Black-Scholes option pricing model with the following weighted average assumptions:

Risk-free interest rate	4%
Expected life	5 years
Expected volatility	50%
Expected dividend yield	Nil

The estimated fair value of the warrants was recognized as a reduction of the common share capital with a corresponding increase to common share performance warrants.

(d) Contributed Surplus

		($000's)
Balance, October 1, 2004	$	–
Stock-based compensation expensed in the period		756
Balance, December 31, 2004	$	756

(e) Stock Options and Special Performance Units

ProspEx has a stock option plan for directors, officers and employees which provides for the granting of options to acquire common shares. Under the terms of the plan, options normally vest equally over a three year period, and expire five years after the date of grant. At December 31, 2004, options to acquire 2.6 million common shares were authorized for issuance under the stock option plan. Changes in outstanding options during the three months ended December 31, 2004 are summarized on the following page:

	Shares (000s)	*Weighted Average Exercise Price*
Outstanding at October 1, 2004	–	–
Options transferred pursuant to the Plan of Arrangement	972	$ 1.70
Granted	1,862	$ 3.23
Exercised	(972)	$ 1.70
Outstanding at end of period	1,862	$ 3.23

ProspEx has a Special Performance Unit plan for directors, officers and employees. Under the Special Performance Unit plan, all of the authorized 1,307,995 Performance Units were granted on October 1, 2004 and remain outstanding at the end of the period. Under the terms of the plan, Special Performance Units (the "Performance Units") vest equally over three years. The number of common shares issuable upon exercise of vested Performance Units are determined by taking the vested Performance Units multiplied by the closing trading price of the common shares less $1.40 divided by the closing price. If the closing trading price less $1.40 is less than zero the Corporation will redeem the Performance Units at a redemption price of $0.01. Once performance units have vested they may be exercised in whole or in part, at any time within 30 days of the vesting date.

The fair value of stock options and Special Performance Units as at the date of grant was estimated to be $2.6 million and $2.8 million respectively, using the Black-Scholes option pricing model with the following weighted average assumptions:

Risk-free interest rate	4%
Expected life	5 years
Expected volatility	50%
Expected dividend yield	Nil

The estimated fair values of the options and the Performance Units are being amortized to expense over the vesting period. For the period ended December 31, 2004, stock and unit-based compensation expense of $756,000 was recorded in the earnings statement.

(f) Per Share Amounts

Basic per share amounts are calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts are calculated based on the treasury stock method, which assumes that any proceeds obtained on exercise of options would be used to purchase common shares at the average price during the period. The weighted average number of shares outstanding is then adjusted by this amount. In computing diluted net earnings per share for the three months ended December 31, 2004, 2,681,015 common shares were added to the weighted average number of common shares outstanding of 42,184,255. A total of 250,000 options were excluded from the diluted calculations as they were not dilutive.

7. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company enters into commodity price derivative contracts to reduce the volatility of expected cash flows.

At December 31, 2004, ProspEx had a costless collar for 2,500 GJ/d with a floor price of $6.00/GJ and a ceiling of $10.56/GJ at AECO. This collar is to expire on October 31, 2005. As at December 31, 2004 the estimated fair value of this financial contract was Nil.

The carrying value of accounts receivable, accounts payable and accrued liabilities approximate their fair value due to their demand nature or relatively short periods to maturity.

A substantial portion of the Company's accounts receivable are with Esprit, as ProspEx was currently marketing on a monthly basis the majority of its production to Esprit.

The Company is exposed to foreign currency fluctuations as oil prices received are referenced to US dollar denominated prices and gas and natural gas liquids prices are influenced by US dollar denominated markets.

8. LONG-TERM DEBT

On October 1, 2004 the Company established a $15.0 million credit facility with a Canadian chartered bank. The facility is available by way of Canadian and US dollar prime rate based loans, LIBOR advances, bankers' acceptances and letters of credit. The credit facility is fully revolving until June 30, 2005 and may be extended at the mutual agreement of ProspEx and its lender for an additional year. If the credit facility is not extended, a balloon payment is required on July 1, 2006. This facility is secured by a $30 million demand debenture and a first floating charge on all petroleum and natural gas assets of ProspEx.

9. ADDITIONAL DISCLOSURES

During the period, there were no cash taxes paid and interest paid was $6,425.

10. COMMITMENTS

The Company has committed to certain payments over the next five years as follows:

($000's)	*2005*	*2006*	*2007*	*2008*	*2009*	*Thereafter*
Technical Services Agreement	94	–	–	–	–	–
Software licenses	29	42	57	–	–	–
Total	123	42	57	–	–	–

Corporate Information

OFFICERS

R. SCOTT GODSMAN
Vice President, Land

JEAN-PAUL (J.P.) H. LACHANCE
Vice President, Engineering

PETER J. LUXTON
Vice President, Exploration

JOHN W. ROSSALL
President and CEO

GEORGE D. K. YEE
Vice President, Finance,
Chief Financial Officer and Corporate Secretary

DIRECTORS

BRIAN E. HIEBERT [1] [2]
Chairman of the Corporate Governance and Compensation Committee
President, B&G Energy
Calgary, Alberta

KYLE D. KITAGAWA [1] [2]
Chairman of the Audit Committee
Managing Director, North River Capital Corp.
Calgary, Alberta

IAN MACGREGOR [1] [2]
President, North West Capital
Calgary, Alberta

JOHN W. ROSSALL
President and CEO, ProspEx Resources Ltd.
Calgary, Alberta

STEPHEN J. SAVIDANT
President and CEO, Esprit Energy Trust
Calgary, Alberta

AUDITORS

KPMG LLP
Calgary, Alberta

SOLICITORS

BENNETT JONES LLP
Calgary, Alberta

BANKER

CANADIAN IMPERIAL BANK OF COMMERCE

INDEPENDENT RESERVES EVALUATOR

GILBERT LAUSTSEN JUNG ASSOCIATES LTD.
Calgary, Alberta

REGISTRAR AND TRANSFER AGENT

OLYMPIA TRUST COMPANY
Calgary, Alberta

STOCK EXCHANGE LISTING

THE TORONTO STOCK EXCHANGE
Trading Symbol: PSX

WEBSITE

www.psx.ca

CONVERSION

All calculations converting natural gas to crude oil equivalent have been made using a ratio of 6 mcf of natural gas to 1 barrel of crude oil equivalent.

[1] Member of the Corporate Governance and Compensation Committee.
[2] Member of the Audit Committee.

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PROSPEX RESOURCES LTD.
700, 606 – 4th Street SW
Calgary, Alberta T2P 1T1
Phone: (403) 268-3940
Facsimile: (403) 268-3987
www.psx.ca

